EBS/13/66
Correction 2

June 21, 2013

To: Members of the Executive Board

From: The Secretary

Subject: **Former Yugoslav Republic of Macedonia—Staff Report for the 2013 Article IV Consultation and First Post-Program Monitoring Discussions**

The attached corrections to EBS/13/66 (5/31/13) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 12, para. 25, lines 1 and 2: for “tail risk events”
read “tail risk events, and that past stress in Europe has not translated into a loss of confidence”

Evident Ambiguity

Page 1, Key Issues, Financial Sector, line 2: for “vulnerable to confidence shocks”
read “vulnerable to low probability confidence shocks”

Questions may be referred to Ms. Vladkova Hollar (ext. 39695) and Mr. Gerard (ext. 39576) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

Other Distribution:
Department Heads

CORRECTED: 6/20/13

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING DISCUSSIONS

May 30, 2013

KEY ISSUES

Context: The authorities have used available margins to lend policy support, mitigating the effects of the euro area crisis on activity and financial conditions. External and financial stability were maintained despite a difficult environment.

Fiscal Policy: In the near term, policies should remain supportive, and the start of the consolidation process should take downside risks to growth into account. However, the relatively rapid rise in public sector debt since the onset of the crisis underscores the need for a well-articulated medium-term fiscal strategy with a deficit path that delivers a gradual reduction in debt. The strategy should aim to safeguard fiscal sustainability, enhance the credibility of the budgetary process, accommodate planned public investment levels, rebuild fiscal buffers, and increase policy transparency.

Financial Sector: The banking sector remains well-capitalized and highly liquid, with a stable domestic financing base, but vulnerable to low probability confidence shocks.

Structural Reform: Despite a long track record of macroeconomic stability, income convergence has been slow. The authorities' strategy to fill infrastructure gaps through public investment and a proactive policy to attract FDI to speed up structural transformation should be complemented by policies that ensure links between new investment and the domestic economy, particularly by absorbing the large pool of unemployed and inactive labor. A number of possible structural impediments to credit supply could be addressed, although their effect is likely to be modest.

Approved By
Ajai Chopra and Dhaneshwar Ghura

Discussions were held in Skopje, April 3–16, 2013. A team comprised of Ms. Vladkova Hollar (head), Messrs. Gerard and Meyer Cirkel (all EUR), and Mr. Tieman (Resident Representative) met with Finance Minister and Deputy Prime Minister Stavreski, NBRM Governor Bogov, other officials; the private sector; media representatives; and others. Mr. Hadzi-Vaskov (OED) joined some of the discussions. At the conclusion of the visit a joint press conference was held with the finance minister. The mission also gave three media interviews. Ms. Mahadewa and Mr. Peterson assisted in the preparation of the staff report.

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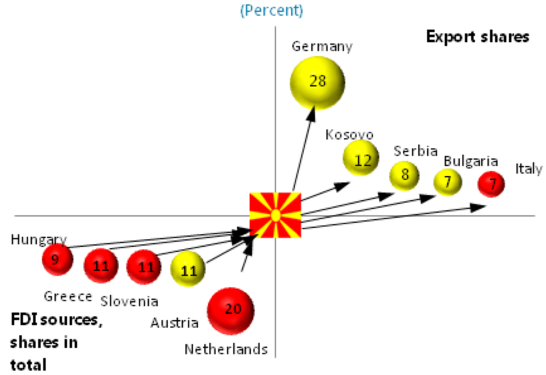
envisages growth to settle around 4 percent by 2016, implying a modest acceleration relative to average growth in the pre-crisis decade but also only a moderate speed of convergence toward living standards in EU countries. Over this horizon, the main risks relate to weaker-than-expected investment and a continued drag of net exports on growth, should there be setbacks in the implementation of FDI plans or difficulties in developing backward linkages to the domestic economy.

22. Despite strong real and financial linkages to the euro area (text chart and Box 1), a number of factors mitigate risks in the near term:

- New tradable sector FDI has reduced reliance on traditional exports and reoriented exports geographically.

Macedonia: Trade and and FDI linkages

(Percent)



Note:
Risk map based on WEO growth projections for 2013 (red < 0%, yellow >0%)
FDI stock data, end 2011. Exports shares data, end 2012.

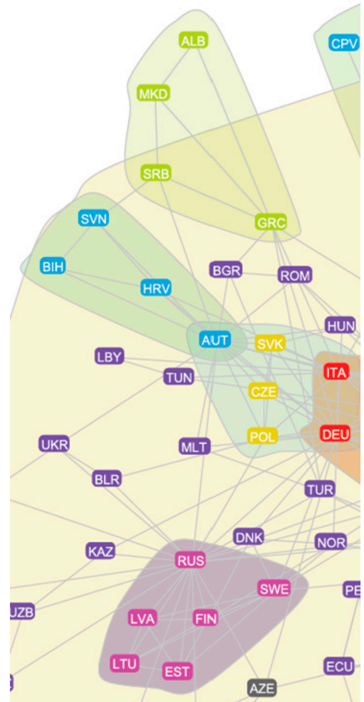
- Local subsidiaries of euro area banks (Greece and Slovenia) are well-capitalized and liquid and have limited exposure to parents—with no short-term wholesale funding dependency—as well as limited credit exposure to those economies.

- With banks funded mainly by resident deposits, and with public sector external financing requirements for 2013 already met, the channels for transmission of any renewed stress in Europe appear limited to relatively low probability but high impact confidence shocks. The short-lived spike in deposit withdrawals from the Macedonian subsidiary of Slovenia's NLB in late March bears testimony to such risks.

23. A sudden loss of confidence could be transmitted through remittances, which are sensitive to domestic conditions. While generally a stable source of current account financing, a sudden stop of remittances—a large share of the 20 percent of GDP in private transfers—has the potential to quickly create large balance of payments pressures, as was the case in 2009. Renewed political uncertainty could affect the volume of these flows.

24. The toolkit for crisis management has been strengthened further. Creating the scope for widening ELA collateral eligibility provides a substantial enhancement of the crisis management toolkit. The standing Financial Stability Committee (FSC) can serve as a useful platform for a regular discussion of risks, and some thought could be given to expanding the membership to include other financial sector regulators such as the Insurance Supervision Agency. In light of the heightened risk of confidence shocks in the current environment, staff suggested that the authorities may want to review the scope of the deposit insurance system, which currently applies only to natural persons.

Box 1. Know Your Cluster-Macedonia[1]

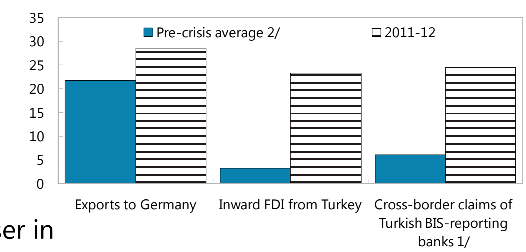


A network analysis of global interconnectedness suggests that Macedonia and its neighboring countries form a tight cluster of economies that are mutually interdependent—more connected to one another than those outside the cluster[2]—with Greece and Serbia acting as likely gateways, connecting the cluster to others. Membership in the cluster reflects the strength of trade, banking, and migrant and remittance links.

Data limitations are unavoidable in any large cross country comparison: in this context, issues of nationality in classifying origin and destination of migrants and remittances, as well as accounting for transshipping of exports through neighbors to Germany may obscure stronger direct linkages to the core.

Nonetheless, this framework is useful in highlighting the following: 1) with two gateways in the cluster, there is greater potential for negative feedback effects within and between clusters; 2) a shock to one member of the cluster may be transmitted more widely to other members through the variety of links that define the cluster. Finally, this broad and systematic approach does not uncover any new sources of spillovers that may have remained hidden by a more narrow focus on bilateral linkages in specific areas.
Looking forward, recent changes in export destinations and FDI and bank flows may have moved Macedonia closer in within the global network, as bilateral links to Germany and Turkey have strengthened.

Trade and Financial Ties since 2010
(Percent of total; unless otherwise indicated)



Sources: Central bank; BIS.
1/ 2011-12 figure is for end-June 2012. Defined in per hundred basis points.
2/ Pre-crisis average 2000-10 for exports, 2007-10 for inward FDI, 2005-07 for cross-border claims.

[1]Franziska Ohnsorge (SPRAM).
[2] The network of bilateral ties as of 2010 in Figure 1 is based on trade, bank exposures, portfolio assets, FDI stocks, migrants, and remittances. A link between a country pair is defined as its share in the average of the two countries' total. To produce the network graph, the links that are "sufficiently large" are aggregated by either taking an unweighted average or choosing the maximum (if the difference between the maximum and minimum link is sufficiently large). See I. Derényi, G. Palla, T. Vicsek, "Clique percolation in random networks" Phys. Rev. Lett. 94, 160–202 (2005). Details of the approach can be found in the IMF Board Paper FO/DIS/12/38.

25. The authorities noted that they are prepared for tail risk events, and the past stress in Europe has not translated into a loss of confidence in the banking sector. The authorities monitor deposits on a daily basis, and have tested bank IT systems' ability to generate reliable insured deposit data on short notice. In case of deposit outflows, they expect to be able to supply the system with ample liquidity on a short notice, which should serve to stabilize the situation quickly. Overall, the NBRM believes that its bank resolution framework is adequate. Deposit insurance coverage and scope are seen as appropriate.